THE CHARTERED INSTITUTE OF TAXATION

The Chartered Tax Adviser Examination

November 2008

PAPER IIB

TAXATION OF INDIVIDUALS, TRUSTS AND ESTATES

Suggested Answers (without marks)

Where candidates are required to comment on tax (and in particular CGT) which may apply in 2008/09 and subsequent years they will be given full credit whether they assume that 2007/08 rates (including taper relief) continue to apply or whether they answer using 2008/09 rates (including entrepreneurs relief).

Question 1

Horsham & Co Accountants
65 Parkside Road
Horsham
West Sussex
RH12 5TT

Mrs K Hofmann
298 Forest Ridge
Horsham
West Sussex
RH10 4NF

Dear Mrs Hofmann

Domicile for IHT Purposes

First of all, I am really sorry to hear about your loss. As your husband died without making a valid will, then you will need to consider the intestacy laws in the various countries where property was held by your late husband.

For IHT purposes, it is important to establish the domicile of Klaus at the date of death as this will have an impact on the IHT liability.

Very briefly, domicile is where an individual considers his permanent home to be and it is different from residence or nationality.

However, there are special rules for IHT which means that a person is considered deemed domiciled if he has been resident in the UK for 17 out of the last 20 years.

The first very important task is to determine exactly when Klaus took up UK residence. If it was when he started his employment in the UK on 15 October 1992, he would have died without having acquired a UK deemed domiciled.

On the other hand, if he became resident in the year before 1992, this would mean that he would have acquired a deemed IHT domicile at the date of death and therefore chargeable on a worldwide basis.

IHT Scope

It is difficult to advise on the IHT scope without first determining Klaus' IHT domicile at the date of this death. With this in mind, briefly, if he had acquired a deemed domicile in the UK, IHT would be charged on all his assets, wherever situated.

Furthermore, if assets pass from Klaus to you and he is found to have a domicile of choice in the UK and you are not, then the inter-spouse exemption would be limited to £55,000 and the remaining assets (to the extent that they exceed the nil rate band, currently £300,000, would be chargeable at 40%).

In contrast, if Klaus is not considered UK deemed domicile, then only the assets that have a UK situs will be chargeable in the UK. So the assets that have a situs outside the UK will not be subject to UK IHT.

Situs of Assets

I have analysed below the situs of the assets:

		£
Residential house in Surrey, joint owned with his wife	UK situs	1,100,000
Savings account balance (Bank of Jersey)	Foreign situs	25,500
Savings account balance (Bank of London)	UK situs	13,500
Shares in Deutsche Telekom AG, a German registered Company	Foreign situs	123,950
House in the outskirts of Dusseldorf	Foreign situs	739,769
Villa in Spain	Foreign situs	576,923
A judgement debt	Foreign situs	26,923
Total estate		2,597,565

Based on the two different scenarios, the chargeable estate would be:

(a) If Klaus was considered as having acquired a deemed IHT domicile by the date of death, he would be chargeable in the UK on his worldwide state, which totals £2,597,595. This, after deduction of any remaining nil rate band and spouse exemption, would be subject to 40% IHT. The amount of spouse exemption will depend on both your IHT domicile and that of Klaus, as explained above.

(b) If Klaus was not considered a having a UK IHT deemed domiciled, then he would only be subject to IHT on his UK situs assets. The only UK situated assets are the Residential house in Surrey and the Savings account in London, therefore the chargeable. estate would be £1,113,500. Again, this would be subject to 40% IHT, after deduction of any available nil rate band and spouse exemption.

I hope the above is helpful and I look forward to discussing further when you have been able to obtain further information on the date Klaus took up residence in the UK.

With kind regards

Yours sincerely

Sue Perkins

Tax Manager

Horsham & Co Accountants

Question 2

A Tax Adviser
Chartered Tax Advisers
High Street
Anytown

Mr J Smyth
Highfield House
Highfield Road
Outskirts
Somewhere

November 2008

Dear Mr Smyth

Priory Manor – POAT & Inheritance Tax Position

As requested, I am writing with a note of the possible tax implications regarding your plans for New Cottage. My understanding is that you will not be acquiring any legal title in the property and it is important that any gift is to Ruth in order to avoid a risk that you have acquired a valuable asset in your estate.

The gift to Ruth will be a potentially exempt transfer (PET) and therefore as long as you survive 7 years from the date of the gift, the amount of these gifts will not impact on the tax on your estate on your death. If you have not already utilised your annual gift exemption of £3,000 for 2008/09 then this will be deducted from the value of the PET, as will the annual gift exemption of £3,000 for 2007/08 if that has also not already been utilised.

However, if you live in New Cottage rent free, then there could be a potential charge to Pre-Owned Asset Tax (POAT), as you will have paid for improvements to the property, or if you later gifted money from the proceeds of sale of your existing house to Rebecca and Samuel.

The POAT charge would arise due to the fact that you would be contributing funds to the improvement of a property that you would have a benefit from, but which you do not own. This is known as the Contribution Principle. A charge to income tax therefore arises and this is designed to replace the inheritance tax that would otherwise have been charged on the capital contribution if it had remained in your estate.

The calculation of the charge can be quite complex as it is dependent on valuation issues. The benefit is assessed on the basis of the rental value of £750 per month or £9,000 per year. However, it is then necessary to adjust this to take into account the value of the disused barn before your funds are applied to it. The tax legislation requires that a reasonable apportionment be used. A possible approach would be to pro-rate the rental value on the basis of the proportion of the expenditure on the property. The resulting benefit would be £9,000 x 150,000/250,000 = £5,400. This amount is above the de minimis threshold of £5,000 per annum and so a tax liability would arise in the first year of £2,160. This could increase if the rental value increases.

The alternative would be to elect back into the inheritance regime such that the POAT charge is avoided but in that case the value of your contribution will remain in your estate and so increase the inheritance tax payable on your death.

Possible Planning Approaches to Minimise Tax

The POAT charge is very modest by comparison to the potential inheritance tax liability and so you may just be prepared to accept the liability arising. However, the POAT charge would be reduced by the payment of rent and so you could simply pay the market rent for the property. However, the rent received would then be taxable on Samuel and Rebecca. A variation on this would be to structure the payment of £150,000 as a lease premium but that is unlikely to be tax efficient overall.

A further possibility would be to make an investment in Priory PR Ltd such that BPR is available after two years. This could be a mechanism for providing Rebecca with funds to expand the business without some of the other inheritance tax and POAT complications. However, even such an approach could potentially be caught by the Contribution Principle which is very wide ranging.

A straightforward planning approach would also be to gift surplus income in order to take advantage of the rules exempting normal expenditure out of income. You should also take advantage of your gift annual exemptions.

I hope that you find the above comments helpful and if you have any further questions then please do not hesitate to contact me.

Yours sincerely

A Tax Adviser

Question 3

To: Mark Dempsey, Audit Manager
From: A Tax Adviser
Subject: Profitable Ventures Ltd – Share Transfers

Where an employee acquires shares in his employing company on favourable terms then this opportunity is deemed to be by reason of employment with one exception (s.421B ITEPA 2003). That exception is where the opportunity is made available by an individual and it is in the normal course of domestic, family or personal relationships. This “let out” could apply here because the gifts have been made by Alan and Simon who are both individuals. However, given the comment about rewarding Roy then it would seem that the gifts are not due to domestic, family or personal relationships. Therefore the value of the gift of shares will represent employment income.

The legislation extends to catching a gift of shares to Sheila as she is associated with Roy for the purposes of these provisions as she is a member of the same household. Hence the value of the share gift will be entirely assessed on Roy.

As Table A applies to the company then in the view of HMRC the shares are subject to restrictions because of pre-emption rights. As a result, in the absence of any other action by Roy or Sheila then the value of the shares that will be treated as employment income will be the actual market value of the shares with the restrictions applying.

You have suggested a value for the shares of £100,000. As Roy is a higher rate taxpayer he will have an income tax liability of £40,000 on the gift. There will be no liability to national insurance as the shares are not readily convertible into cash.

Profitable Ventures Ltd needs to return the gift of shares to HMRC on form 42 which must be filed by 6 July following the end of the tax year in which the gift occurs. Roy will need to include the gift of the shares on his self-assessment tax return and pay the income tax liability arising by 31 January following the end of the tax year in which the gift occurs. Roy is likely to have to make payments on account because of this liability but should be able to make an application to reduce them subject to his other income.

As the shares are subject to restrictions then on a future sale or the occurrence of certain events a further charge to income tax will arise on the restricted element (in this case 10% of the share value or proceeds). This can be avoided by Roy entering into a s.431 election with the company and paying income tax now on the full unrestricted share value. However, to do this urgent action is required as the s.431 election must be entered into within 14 days of the date of the share transfer.

The employment income charge arising under ITEPA does not replace the need to consider the capital gains tax (CGT) position. To avoid a CGT liability, Alan and Simon still need to enter into hold-over elections with Roy and Sheila. However, the employment income charge is treated as additional CGT base cost for Roy and Sheila. As such their base cost is the current market value of £100,000. Alan and Simon will still need to make appropriate entries on their tax returns for CGT purposes in respect of the share disposals.

An alternative approach would have been to consider structuring the arrangements as an option within the Enterprise Management Incentive (EMI) rules.

Question 4

	Non Savings	*Savings*	*Dividends*	*Tax Credits*
	£	£	£	£
Traumelia Ltd	5,000			–
Foreign Bank interest				
(£3,575 x 100/65)		5,500		1,925
Interest received gross		875		–
Bank interest rec'd net				
(£6,082 x 100/80)		7,603		1,521
State retirement pension	3,830			
Just Retirement	47,408			10,428
Large PLC				
(£160 + 74 = £234 x 100/90)			260	26
Total Income	56,238	13,978	260	
Personal Allowance	(5,225)	(A)		
Taxable income	51,013	13,978	260	13,900

Tax thereon:

£		£	
2,230	at 10%	223	
38,333	at 22%	8,433	(W1)
10,450	at 40%	4,180	
13,978	at 40%	5,591	
260	at 32.5%	85	
65,251		18,512	

	£	
Allowances and reliefs:		
Foreign tax credit relief	(1,925)	(B)
EIS subscription: £20,000 x 20%	(4,000)	
Married couples allow. £2,440 x 10%	(244)	
	12,343	
Tax due after allowances & reliefs	12,343	
Non-repayable tax credits on dividends	(26)	
	12,317	
Tax paid at source		
Just Retirement	(10,428)	
UK Bank Interest	(1,521)	
Income tax due	368	
Capital Gains	0	(W2)
1st Payment on account - 31/01/2009	0	(F)
Total due on 31/01/2009	368	
2nd Payment on account - 31/07/2009	0	(F)

Workings:

	£
(W1) Basic Rate Band Extension:	
Lower and Basic Rate Band	34,600
Gift Aid £4,651 x 100 / 78 =	5,963
	40,563

	£	
(W2) Capital Gains		
Piccadilly Photo Framers Ltd		
Disposal 31/12/2007	38,750	
Acquisition 05/07/1998	(6,250)	
Net Gain	32,500	
EIS deferral	(4,134)	(C)
Taper Relief	(19,166)	(W3)
Net Gain / (Loss)	9,200	
Annual Exemption	(9,200)	
Chargeable Gain	0	

(W3) Taper Relief

			Complete Months
Non-business taper	05/07/1998 to	05/04/2000	21
Business taper	06/04/2000 to	31/12/2007	92
			113

	Total	*NBATR*	*BATR*
Net Gain (£32,500 - £16,518)	£28,366	£5,271	£23,094
BATR at 75%			£(17,321)
NBATR at 35%		£(1,845)	
Total taper relief		£19,166	

(a) Graham's income is so high so that he cannot access the Personal Age Allowance, however he is entitled to the basic allowance.

(b) As the UK tax on the foreign income is 40%, there is no restriction to the FTC.

(c) EIS deferral is restricted in order not to waste taper relief and the annual exemption. (Candidates with knowledge of the new rules who suggest that it is better to pay the CGT and take the taper relief whilst still available will also receive the same number of marks).

(d) Although the disposal of the car generates a gain, this is specifically exempt under the Capital Gains Tax legislation (s250 TCGA 1992).

(e) Shares held in a Individual Savings Account (ISA) are exempt from CGT.

(f) No POAs will be required as total tax outstanding is less than £500.

Question 5

1 **Income Tax Position for 2007/08**

Adjustment of Profits on Trading Income

		£	£
Profit per accounts			23,586
Add:			
Depreciation			16,733
Less:			
Land & property income –	rental income	78,000	
–	expenses (10% of overheads)	(44,280)	
			(33,720)
Capital allowances			
£95,683 * 25%			(23,921)
			(17,322)

Income Tax Computation

		Doug	*Tony*
	£	£	£
Land and property income	33,720	16,860	16,860
Less: trading losses	(17,322)	(8,661)	(8,661)
		8,199	8,199
Personal allowance		(5,225)	(5,225)
		2,974	2,974
Income tax liability			
10%	2,230	223	223
22%	744	164	164
	2,974	387	387

If the business had incorporated on 31 March 2008 then the maximum loss claim could have been increased because of the balancing allowance rather than the claim for writing down allowances.

The balancing allowance would have been £35,683 (£95,683 – 60,000) which would then give a loss of £29,084. Whilst this would have prevented any income tax liability from arising it would not utilise the additional tax losses very tax efficiently as once the loss claim exceeded £23,270 then it is covering income that would already have been within their personal allowances. In any case most of the additional losses are only relieved at 10%.

2 **Capital Gains Tax on Incorporation**

Section 162 is a specific incorporation relief for CGT that applies to businesses whereas s165 is a hold-over relief for business assets and can only be claimed on an asset by asset basis where the asset concerned is used within a trade.

In this case the chargeable assets are the property assets (both trading and letting properties) and goodwill if there was any. The Newbay repair yard property and any goodwill are eligible for s165 as they are used within a trade. However s165 could not apply to the residential properties.

Potentially s.162 could apply to both the letting and the trading assets as long as they comprise a single business. This is a question of fact and the tests are derived from case law decisions, mostly in respect of IHT BPR. In this case there must be some uncertainty as to whether or not s.162 would definitely apply and the issue is principally whether the trading and letting activities are an integral whole forming one activity as opposed to separate jointly owned trading and investment activities.

	£
Newbay repair yard	700,000
Residential properties	1,385,000
Plant & machinery	60,000
	2,145,000
Net current liabilities transferred to the company	(127,100)
	2,017,900
Amount of share capital	(2,000,000)
Balance left on loan account split equally between Doug and Tony	17,900
Gains on properties:	
£2,085,000 – 1,261,100	823,900
Gain deferred:	
£823,900 * 2,000,000/2,017,900	816,592
Base cost of shares:	
£2,000,000 – 816,592	1,183,408

There is a gain immediately chargeable of £7,308 (£3,654 each) which is covered by annual exemptions.

3 **Potential Tax Disadvantages**

Capital gains – On a future sale of any of the properties then there is a potential double charge to tax as a capital gain will arise in the company whilst monies will still have to be extracted with further tax liabilities potentially arising.

SDLT – There would be an SDLT liability on the transfer of the properties into the company.

Income tax – Doug and Tony each have brought forward trading losses of £223,571. These will not carry forward against future trading profits. Instead it will only be possible to relieve them under s.86 ITA 2007. This relief is available if the incorporation is satisfied by a consideration wholly or mainly in the form of shares. The losses will be carried forward and set against dividend income and directors' remuneration. If the aim is to retain profits in the newly incorporated business in order to settle liabilities then a tax liability will arise where it would not otherwise have done so.

Share capital – if the level of share capital was reduced slightly and the loan account balance increased then the immediate capital gain would be higher. This could be planned for a level that utilises Doug and Tony's annual exemptions.

Question 6

		£	
1	Gift (1/5/98)	300,000	
	AE (98/99)	(3,000)	
	AE (97/98)	(3,000)	
	CLT	294,000	

This is a gross gift as the trust pays the tax therefore no grossing up is required.

	£	
Less: NRB (98/99)	(223,000)	
Taxable	71,000	
Tax payable by tustees	14,200	By 30 April 1999

		£
2	Gift (12/2/02)	250,000
	AE (01/02)	(3,000)
	AE (00/01)	(3,000)
	PET	244,000
	(No lifetime tax)	

		£
3	Gift (13/2/02)	250,000
	No AEs	
	PET	250,000
	(No lifetime tax)	

		£
4	Gift (15/8/02)	15,000
	Marriage exemption	(5,000)
	AE (02/03)	(3,000)
	PET	7,000
	(No lifetime tax)	

5 Paintings – use loss to donor principles

	May 2003	*May 2004*	*May 2005*	*May 2006*
	£	£	£	£
Before	10,000	11,000	12,000	13,150
After	(7,500)	(4,850)	(1,870)	–
Diminution in Value	2,500	6,150	10,130	13,150
Less previously assessed:				
May 2003	–	(2,500)	(2,500)	(2,500)
May 2004	–	–	(3,650)	(3,650)
May 2005	–	–	–	(3,980)
Value of Gift	2,500	3,650	3,980	3,020
Annual Exemption	(2,500)	(3,000)	(3,000)	(3,000)
Unused from prior year	–	(500)	–	–
	0	150	980	20

On death (13/08/08)

1. CLT of 1/5/98 > 7 years therefore no further tax due.

2. PET of 12/2/02 becomes chargeable:

	£	£	
NRB on death		300,000	
Less GCTs in 7 years to 12/2/02		(294,000)	
Remaining NRB		6,000	
PET 6,000 @ 0%			
238,000 @ 40% =	95,200		
244,000			
Taper relief (6 – 7 years) 80%	(76,160)		
IHT	19,040		payable by Mark (donee) by 30/9/08

3. PET of 13/2/02 becomes chargeable. Peter (donee) can use reduced value of property at date of death, in calculating IHT (provided he still owns the house).

	£	£	
NRB on death		300,000	
GCT (1/5/98)		(294,000)	
GCT (12/2/02)		(244,000)	
Remaining NRB		Nil	
PET £210,000 (reduced by fall in value)			
@40% =	84,000		
Taper relief 80%	(67,200)		
IHT	16,800		payable by Peter (donee) by 30/9/08

4. PET on daughter's marriage becomes chargeable (15/8/02)

	£	£	
NRB on death		300,000	
(again, all used by CGTs in 7 years to date of Gift, to sic. Trust, Mark & Peter)			
PET £7,000 @ 40%	2,800		
Taper relief (5-6 years) 60%	(1,680)		
IHT	1,120		payable by Amelie by 30/9/08

5. PET on May 2005 painting becomes chargeable

	£	£
NRB on death		300,000
It is assumed that gift to disc. Trust 1/5/98 is more than seven years prior to this gift		
CGT (12/2/02)	(244,000)	
CGT (13/2/03)	(210,000)	
CGT (15/8/02)	(7,000)	
Remaining NRB	Nil	

Paintings – Death Tax Payable

May 2003
The May 2003 transfer was covered by the annual exemptions.

May 2004

PET of £150		
IHT @ 40%	£60	
Taper relief – 20%	£(12)	
IHT payable	£48	30 September 2008

May 2005

PET of 980		
IHT payable at 40%	£392	30 September 2008

No taper relief due as gift < 3 years before the date of death.

May 2006

PET of £20		
IHT payable @ 40%	£8	30 September 2008

No taper relief due as gift < 3 years before the date of death.

Total IHT due on paintings	£448

House bequeathed by Will to Amelie: No Quick Succession Relief as he inherited this in mid 1990s, more than five years ago.

Only specific gift is £450,000 house to daughter, which is chargeable. The whole of the residue is exempt (to wife), hence single grossing is required in accordance with s211 IHTA 1984. This specific gift is treated as a net transfer.

	£	£
Tax free legacy (house)		450,000
NRB on death300,000	300,000	
GCTs in 7 years to death >	(300,000)	
Remaining NRB		–
		450,000
IHT thereon @ 40/60		300,000

Payable out of residue on delivery of account by 30/9/08 (instalment option can be claimed with one tenth payable 30/9 each year first).

The value of estate after tax is:

£1,250,000 – 300,000 = £950,000 and this is divided:-

£450,000 to daughter

£500,000 to wife